Summary:
Deutsche Lufthansa AG

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Credit Rating: BBB-/Negative/A-3

Rationale

The ratings on Germany-based aviation group Deutsche Lufthansa AG are supported by, in Standard & Poor's Ratings Services' opinion, its strong market positions, good exposure to high-yield premium traffic, the diversity in its operations, and its healthy balance-sheet structure. We consider that these strengths are partly offset by the high-risk, cyclical airline industry; the adverse effects of the current weak economic environment on corporate and consumer demand; and volatile fuel costs.

Key business and profitability developments

The global economic crisis in 2009 resulted in a reduction in both passenger and cargo demand and a fall in average yields as passengers migrated to cheaper ticket classes, price competition increased, and fuel surcharges were lowered. As a result of these very weak industry conditions, Lufthansa reported total revenues for full-year 2009 of €22.3 billion, down 10.3% on 2008.

On a like-for-like basis, excluding the impact of acquisitions during the year (which notably included British Midland Ltd. group [BMI] with effect from July 2009 and Austrian Airlines AG group [Austrian] with effect from September 2009), total revenues would have been 15% lower than the prior year's. During a period when many airlines were reporting substantial operating losses, Lufthansa reported a positive operating result (excluding nonrecurring factors) for 2009 of €130 million with some year-on-year cost benefits from lower fuel prices. Although this was substantially less than the €1.3 billion reported for 2008, it remains in line with our expectations for the ratings.

For the seasonally weak first quarter of 2010, Lufthansa reported an upward trend in demand, particularly for its cargo operations, which, combined with additional revenues from the BMI and Austrian acquisitions, resulted in revenue growth of 14.8% to €5.8 billion. However, average yields remained weak, notably in the passenger airline group, as passengers continued to prefer lower booking classes, and higher demand was offset by the re-introduction of capacity to the market.

Lufthansa's costs also increased as a result of the consolidation of the currently loss-making acquisitions and from higher fuel costs, which were compounded by a weaker euro. Lufthansa was also adversely affected in the first quarter of 2010 by disruption from unusually severe winter weather and industrial action, and reported a negative operating result of €330 million, compared with the €44 million loss for first-quarter 2009.

However, underlying industry conditions now appear to be improving, and, notwithstanding the further disruption in April from the Eyjafjallajökull volcano, Lufthansa remains optimistic that it will achieve a positive operating result, higher than that for 2009, for full-year 2010, helped by cost savings from its Climb 2011 cost-savings program.

Key cash flow and capital-structure developments

Notwithstanding the higher operating losses in first-quarter 2010, cash flow from operating activities for the rolling 12 months to March 31, 2010, remained positive at €1.85 billion, and only 7% lower than the €1.99 billion generated for 2009. Credit ratios for the rolling 12 months to March 31, 2010, generally declined in comparison with the same period a year earlier, and were also slightly weaker than for 2009. However, they remain broadly in line with levels we consider to be commensurate with our current ratings (as reflected by the ratio of funds from operations [FFO] to adjusted debt of 23.1%). We currently consider a ratio of FFO to adjusted debt of 25% to be commensurate with a 'BBB-' rating for Lufthansa.

Short-term credit factors

The short-term rating is 'A-3', which reflects our view of Lufthansa's liquidity, which we classify as adequate. On March 31, 2010, Lufthansa reported cash, cash equivalents, and short-term securities totaling €4.4 billion. We understand from the company that, at the same time, €228 million of longer-term investment securities, classified in the balance sheet as noncurrent, are liquid and available at short notice if necessary, and that it also had €1.7 billion of unused committed 364-day credit lines. We anticipate that free operating cash flow for 2010, after about €2.1 billion of capital expenditures but before any payments to the Lufthansa Pension Trust, will be marginally positive.

In the context of this liquidity, debt maturities for the next 12 months, totaling about €685 million on March 31, 2010, look manageable. The management team has advised us that it is the group's intent to maintain at all times a minimum liquidity of €2.3 billion, excluding availability in credit lines.

Outlook

The negative outlook reflects our view that Lufthansa's credit profile is likely to remain weak for the rating category in the near term, with the financial profile constrained by a still weak trading environment. Although the economic outlook is uncertain, we factor into our ratings a slow and fragile recovery for the European airline industry in 2010, and anticipate that the company's financial profile will improve slightly with the ratio of FFO to adjusted debt increasing to about 25% by the end of 2010, which is commensurate with the current ratings.

A key support to Lufthansa's performance will come from the group's Climb 2011 cost-savings program. Failure to satisfactorily adapt the cost base in line with management's plans, a further deterioration in operating performance, or a rise in adjusted debt levels could lead to downward pressure on the ratings.

A sustained improvement in industry conditions, along with an improved trading performance from Lufthansa that returned key credit ratios to levels we view as commensurate with the ratings, could result in the outlook being revised to stable.

Related Criteria And Research

- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Key Credit Factors: Business And Financial Risks In The Airline Industry, Sept. 18, 2008

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